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Banhalmi-Zakar, Zsuzsa; Larsen, Sanne Vammen

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How Strategic Environmental Assessment can inform lenders about potential environmental risks

Zsuzsa Banhalmi-Zakar, Griffith University, Australia

Sanne Vammen Larsen, Aalborg University, Denmark

Abstract

In this paper, we explore the potential for Strategic Environmental Assessment (SEA) to be a useful tool for banks to manage environmental risks and inform lending decisions. SEA is an environmental assessment tool that was developed to assist strategic-level decision-makers, such as policy-makers, planners, government authorities and environmental practitioners in improving developmental outcomes, aiming to facilitate the transition to sustainable development. We propose that SEA may also be a valuable tool for banks because it has the capacity to provide information about environmental risks at a time when it can be used as an input to bank lending decisions, which can assist banks in making lending decisions with better environmental outcomes. For these reasons, we argue that in some circumstances, and particularly for project finance transactions, SEA may be a more useful environmental assessment tool for lenders than EIA, which many banks are currently relying on to help assess and mitigate environmental risks. Further we suggest that the use of SEA by banks would contribute to the sustainability goals of SEA.

Keywords: environmental risk, Strategic Environmental Assessment, project finance, sustainable development

Introduction

Over the past decade, the bank sector has shown a growing interest in the environmental and social risks associated with the projects they finance. This is largely due to the incorporation of voluntary environmental and social measures by banks such as the introduction of the Equator Principles (EP) in 2003. The EP calls on banks to take the environmental and social risks associated with projects with a capital cost over USD 10 million into consideration in their lending decisions and refuse to finance projects that do not meet basic environmental

and social standards (The Equator Principles Association, 2011). In essence, the EP is a guideline for responsible lending practices for commercial banks and as such, it brings this responsibility out of the realm of multilateral development banks (such as the World Bank, the Asian Development Bank, the European Bank for Reconstruction and Development and other members of the World Bank Group), where it had a long tradition, and into the competence of commercial banks.

The EP applies to projects financed through project financing¹, which is the mechanism that banks tend to use to finance large-scale, complex projects, such as power plants, major infrastructure works, mining projects, dams, *etc.* (Equator Principles, 2006). These projects are often associated with potentially substantial environmental and social impacts and consequently, require approval from environmental authorities triggering an EIA process and can attract considerable attention in the media. The EP is based on the International Finance Corporation (IFC) Performance Standards on social and environmental sustainability, which utilise the outputs of the EIA process, namely the environmental impact studies (EIS) and the environmental management plans (EMP), to assist lenders in assessing and mitigating environmental and social risks (The Equator Principles Association, 2011).

Currently, 78 financial institutions operating in 35 countries have adopted the EP, representing a substantial share of global project finance debt (The Equator Principles Association, 2011). Given the number of adopters and the volume of large-scale projects that each institution finances, the EP has the potential to impact on a substantial share of projects. It is not surprising then that it has been hailed as a major step towards sustainable development (Lawrence, 2009). However, the EP has not been immune to criticism, particularly from non-governmental organisations who have condemned its ability to deliver what it has endeavoured to do; *i.e.* to enable the realisation of more sustainable projects on the ground (O'Sullivan and O'Dwyer, 2009; Macve and Chen, 2010). One aspect of this question that has been overlooked so far is whether EIA can live up to the expectations of the adopters of the EP and deliver the type of information they need, particularly since little is

¹ Project financing is defined as a type of non-recourse financing where the loan is repaid from the future cash-flow of the project (The Equator Principles Association, 2011).

known about how banks can utilise the outputs of the EIA process and the actual internal project lending (or project finance) practices of banks (Banhalimi-Zakar 2014, Esty 2004, Romih 2008). In this paper we argue that SEA may be well placed to provide lenders with information about environmental and social risks of projects, and that in some cases it may be better suited as an information source than EIA. Furthermore, we argue that bankers' use of SEA in this manner also contributes to fulfilling the fundamental goals of SEA.

The argument presented in this paper is based mainly on knowledge of the operative steps in the lending process and lenders' environmental information needs gained through an in-depth empirical study of the role of environment in bank lending practices in a European and an Australian commercial bank² conducted in 2006 and 2007 (Banhalimi-Zakar 2014). This is combined with literature and experience of SEA theory and practice to view the connections between the two. Combining information and evidence from the literature, experience, and observation has been identified as a valid strategy to propose and explore a concept which serves as the precursor to theory (McLean, 2011). Thus, at this point we are proposing a conceptual development focussed on a possible new role for SEA. We hope this can serve as a starting point for dialogue among scholars and practitioners to review, debate, test, and put this into practice.

Environmental information needs of lenders

Lenders require information about environmental issues associated with projects that can help them identify and assess the financial risks and opportunities that the environment can represent. The notion that the environment can materialise as financial risks and opportunities for banks in lending is well established in the literature and the study of the two banks further supported this notion. Often referred to as 'environmental risks', these risks have been identified as a type of customer or counterparty risk falling into three categories: direct, indirect and reputational risks (Missimer 1996, Thompson 1998a, Thompson 1998b, Case 1999). Direct risks arise when banks become directly liable for cleaning up contamination on a site taken over when the borrower defaults on the loan (i.e. where the site is the security for

² The names of the banks cannot be revealed due to the confidentiality agreement between the researcher and the banks.

a loan) (Case, 1999; Cowton and Thompson, 2000; Jeucken, 2001). Indirect risks arise when a borrower's ability to repay a loan is hindered as a result of environmental issues (Thompson, 1998a; Case, 1999; Jeucken, 2001; Thompson and Cowton, 2004), such as when a borrower incurs costs to upgrade existing facilities to meet more stringent environmental standards. Reputational risk arises when a lending institution is perceived in a negative light because the project is perceived to have a harmful effect on the environment and society (Thompson 1998, Case 1999, Jeucken 2001). Reputational risk has been identified as the most difficult type of risk to manage that can potentially affect all areas of a banks' business not just the department that was directly involved in a transaction (Case, 1999; Jeucken, 2001). Large commercial banks and development banks have been deemed as most susceptible to reputational risk (Case, 1999). Reputational risk manifests as missing out on new clients and losing existing ones (Jeucken, 2001). Non-governmental organisations (NGOs) play a crucial role in increasing the reputational risk exposure of banks by drawing attention to their involvement in projects with potentially significant environmental and social impact, putting pressure on them to act in a more responsible manner (Jeucken 2001, Coulson 2009).

How SEA can contribute to the environmental information needs of lenders

We suggest that SEA can provide environmental information for banks in two main areas:

- 1) Information about environmental risks that stem from the potential impact of projects (indirect environmental risk)
- 2) Indication of possible public controversy over proposed projects (which informs reputational risk exposure)

Regarding the first point, we suggest that SEA can identify possible and significant environmental impacts likely to result from a PPP³ and can be used to provide facts about the environmental risks connected to them. In general, SEA aims to achieve sustainable development through ensuring the integration of environmental issues into decision-making

³ PPPs are policies, plans and programmes which in literature often are defined as the relevant strategic actions for decision-making (Therivel 2004, 12; Fischer 2007, 2; Jones et al. 2005, 6).

at the strategic level, promoting more sustainable decisions, more sustainable PPPs⁴ and ultimately, more sustainable actions and projects (Therivel, 2004; Kørnøv and Christensen, 2007a; Fischer, 2007). Thus SEA, as well as EIA, are essentially predictive tools that are inherently about the future, since they attempt to predict and evaluate future negative as well as positive impacts of development. Although not explicitly framed as a risk assessment tool, impact assessment tools such as SEA have been used to inform decision-makers about possible environmental and sustainability risks (see e.g. Sheate and Partidário, 2010; Corvellec and Boholm, 2008). Figure 1 shows how SEA may be able to contribute information about environmental risk at various stages.

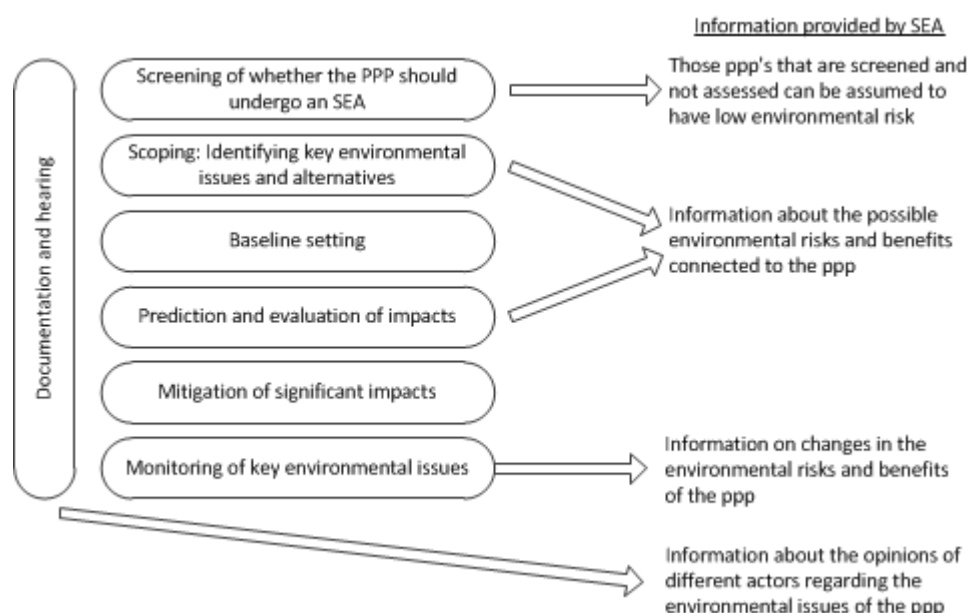


Figure 1. Main stages in a generic SEA process and how they can contribute to lender's needs to address environmental risk. The generic SEA process on the left is based on (Kørnøv and Christensen 2007a)

In practice, SEA is applied as an assessment tool internationally in a variety of sectors, including agriculture, water, forestry, transport, oil and gas extraction, economic development planning, waste management, flood management, wind power, funding programmes, industry and spatial planning (UN University and Oxford Brookes University, n.d.; Fischer 2007). The empirical investigation of the lending practices of the two banks revealed that the European bank had identified target sectors (e.g. projects dealing with the production, distribution, equipment manufacturers and servicing of energy, wood, paper,

mining, chemical industry, mining, machinery, automotive and electrical manufacturing industries, utilities including waste, water and electricity provision), restricted sectors (e.g. textile industry, telecommunications) and excluded sectors (e.g. nuclear energy and airlines) in its corporate credit policies. Thus, SEAs are being carried out in a number of the sectors that the bank wanted to target. SEAs provide insights into the environmental risks for sectors which, we suggest, banks can utilise to identify target, restricted or excluded sectors and can incorporate into their credit policies.

SEAs carried out for land-use plans can help banks identify environmental risks associated with developments in specific locations. The empirical study of lending revealed that the bulk of the projects financed in the two banks were realised in the same locations (urban and peri-urban areas) and that up to 70-80% of new project finance transactions originated from existing clients. Knowledge about potential environmental sensitivity of an area that banks are actively financing in could help them anticipate possible environmental risks. For example an SEA of a programme of offshore wind turbines can provide insights into the environmental risks associated with coming wind turbine projects in very specific locations (e.g. Danish Energy Agency, 2007). SEAs of land-use plans may also help identify environmental risks in municipalities that are clients, as was the case with one of the banks investigated. SEAs of land-use plans can provide insight into the environmental risks arising from a range of projects proposed in a specific area, such as the construction of a new metro line, office and residential buildings that will result from the implementation of municipal plans (e.g. Municipality of Copenhagen, 2011).

Regarding the second point on reputational risk, one of the key elements of the SEA process is that it aims to facilitate transparency and democracy regarding environmental information through documentation, communication and public participation (Kørnøv and Christensen, 2007a; Therivel, 2007; Chaker *et al.*, 2006). Fischer (2007, p. 13) formulates it as “*in SEA, communication, participation and reporting have an important role to play by introducing perspectives and inputs of different stakeholders to the PPP making process*” where one of the possible benefits is “*the identification of public concerns*”. Although the form of public consultation applied in SEA can vary, as a minimum it must be able to provide information about the problems the public identify in relation to a PPP (Fischer, 2003). Through this, SEA

can provide insight into whether parts of a PPP may be controversial, which can materialise into reputational risk for lenders. Reputational risk has been identified as the most damaging risk to banks (Jeucken, 2001; Case, 1999). The empirical study provided further support that reputational risks associated with projects are difficult to assess and manage but can carry substantial leverage. Even if PPPs appear not to have significant environmental impacts and are positive in terms of their overall objective, they may still not be acceptable to the public. For example plans for installation of land-based wind turbines have an overall positive impact on the environment, but their noise impacts have aroused much public controversy in some regions (see e.g. National Association for Better Environment, n.d.). Through SEA, Banks could identify not only the nature of potential opposition, but also the groups (e.g. NGOs) that oppose PPPs and ensure that their concerns have been dealt with adequately by clients and regulators.

Risk of non-approval by the relevant authorities (environmental or other development authorities) has been identified as a major environmental risk in the banks that were studied and in the literature, materialising as a form of regulatory risk (Banhalimi-Zakar 2014, Barannik 2001, Jeucken 2001). This is because many projects are financed on a cash-flow basis, which means that banks depend on the future cash-flow of the project for loan repayments. Since the bulk of the loan is withdrawn during the construction phase, banks are left “running after their money”, as bankers described. Thus non-approval undermines the viability of projects ultimately risking its ability to repay the loan. Similarly, delay in project approval also represents financial risk for banks. Thus it is in the banks’ interest to ensure that projects are realised and can start operating on time. SEA can provide insight into whether permissions by relevant authorities are likely or may be problematic because in some SEA systems, SEA involves actively seeking preliminary input from public authorities in a form of a hearing. This could provide lenders with invaluable information early on, who may be able to offset a considerable potential risk.

The suitable timing of SEA

An important characteristic of SEA is that it is intended to ‘get in early’ in the planning process. The idea is that there is more potential to affect outcomes early on in the process,

because many interim decisions are still open to debate and negotiation (Bina, 2007). In contrast, an EIA will only come into play at the project level, when preliminary decisions about the project activity have already been made and the focus of the EIA is on environmental optimisation.

SEA is carried out at the conception stage of projects, along with other pre-feasibility assessments. In comparison, EIA is carried out well into the planning stage, but prior to approval and the start of construction. Bank lending decisions must also precede construction, typically taking place during the planning stage (Harou et al., 1994). Only limited information exists on when lenders become involved in project planning, however the case study of the lending practices of the two banks revealed that banks employ two types of approaches. One approach involves processing nearly fully complete loan applications that include detailed project plans, documents and copies of necessary approvals provided by the clients. In these instances, if environmental reports or EIAs were required, they are already prepared and are available to lenders (normally attached to the application). The other approach is much more involved on the lenders' part because bankers are exposed to projects much earlier. In these cases, lenders are more proactive as they seek out projects to finance (through their existing client relationships), and then work through the feasibility and financing options with the clients. Projects financed this way in the banks that were investigated included complex and large-scale projects (e.g. waste management plants, wind farms, major transport infrastructure like airports, ports, tunnels, etc.). While the first approach does not leave many options for the banks to provide input into planning, approval or feasibility assessment, we believe the second approach is where SEA could be particularly useful for lenders. Early on in project planning no decision has been made on the project by relevant authorities and EIAs are not yet available. However, SEAs are available and, it is argued, that they are better placed to provide information about environmental risks related to large-scale and complex projects that can carry substantial environmental impacts than EIA.

Discussion and conclusions

Based on an understanding of the nature and timing of environmental information needs of banks, we propose that SEA may be an effective tool for lenders to identify and assess

environmental risks that can arise from lending. We described how SEA documents become available to stakeholders, including the wider public, at a time when lenders contemplate whether to finance large-scale and complex projects where environmental and social impacts often arise. We showed how SEA can provide information about indirect environmental risk and information about how the public would react to developments, which can help banks estimate the likelihood and severity of reputational risks. This is an especially important benefit of SEA since reputational risk is the most difficult risk to manage for lenders. We have also argued that SEA can, in some instances, provide information about the likely outcome of approval processes and help forecast any regulatory issues, which again, has been identified as a key source of environmental risk. We believe that these features of SEA could be especially useful for banks that have signed the Equator Principles because lenders tend to become involved early on in the planning phase of complex and large-scale projects that fall in the realm of the Principles.

In turn, we argue that use of SEA by banks can contribute to the purposes of SEA to influence PPPs and, in the end, actions on the ground. This influence is most often sought through the decision-makers responsible for the PPP, traditionally public and private organisations traditionally. We suggest that banks hold a relatively unexplored potential for SEA to inform which projects they invest in but that through their investment decisions ultimately influence which projects will be implemented and how.

We do not necessarily propose that banks should carry out SEA, but that they could use it to inform their lending decisions and achieve their sustainability goals such as adhering to the Equator Principles. Perhaps, they could consider commissioning SEA for specific sectors for instance, which could serve their own purposes. In light of this, it is important that lenders, as potential users of SEA, understand its limitations. In this paper we highlighted the potential benefits that SEA should be able to provide, but of course the value and utility of any tool rests largely on how it is carried out. Consequently we draw attention to some of the problems and issues that have been identified with SEA in practice, including:

- its inability to always ‘get in early’ as sometimes SEA of PPPs are carried out simultaneously with the project-level EIA,

- weakness in public participation because strategic issues do not interest the public as much as specific projects do (see for example Elling, 2009; Therivel, 2004; Kørnøv and Christensen, 2007b; Nilsson and Dalkmann, 2001)

The arguments raised in this paper are suggestions for topics for further research, analysis and discussion. We believe that the next step is to test the potential of SEA as a tool for lenders empirically in an effort to identify whether SEA can be utilised by bankers at its current state of practice, which parts of SEAs hold the most potential for bankers, and what form of environmental information they may best be able to utilise.

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